

RESEARCH NOTE

# Tariff Flexibility Amid Formation of Preferential Trade Agreements: WTO Law vs. PTA Law

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## Abstract

This paper examines the legal ramifications of using tariff flexibility arising from GATT unbound tariff lines or tariff overhangs under both WTO and preferential trade agreement (PTA) law when flexibility is exercised preferentially for PTA partners. Under WTO law, a WTO member that is a party to a PTA under GATT Article XXIV is required to use tariff flexibility on a non-discriminatory basis. However, PTA obligations including tariff elimination commitments and a standstill clause prohibit the WTO member from raising applied tariffs on imports from the PTA parties, thereby preventing the use of tariff flexibility on a non-discriminatory manner. In contrast, a WTO member entering into a PTA under the Enabling Clause may use tariff flexibility discriminatorily without violating WTO law. A WTO member has greater legal latitude in utilizing tariff flexibility if it forms a PTA under the Enabling Clause rather than under GATT Article XXIV. The discriminatory exercise of tariff flexibility by some WTO members in conformity with PTA obligations, but in violation of WTO law, is further evidence of the fragmentation of the world trading system, where WTO law is facing its limits.

**Keywords:** Tariff flexibility; preferential trade agreement; MFN; GATT article XXIV; enabling clause

## 1. Introduction

The world trading system under the GATT is built on the principle that applied tariffs shall not exceed GATT-bound tariffs.<sup>1</sup> This principle aims ‘to protect not only existing trade but also the security and predictability needed to conduct future trade’.<sup>2</sup> However, the structure of GATT binding schedules of tariff commitments includes tariff flexibility that potentially undermines the security and predictability of the trading system. There are two kinds of tariff flexibility ‘built into’ GATT schedules of tariff concession. The first kind arises due to tariff lines that are not bound under GATT Article II.<sup>3</sup> For tariff lines that are not bound, a WTO member can raise applied general Most-Favoured-Nation (MFN)<sup>4</sup> tariffs without any binding constraints (Beshkar et al., 2015). The second kind arises from tariff lines with tariff overhang, where a gap

<sup>1</sup>WTO members’ GATT bound tariffs are provided in the schedule of tariff concessions annexed to GATT Article II.

<sup>2</sup>See WTO Panel Report, *Russia–Tariff Treatment of Certain Agricultural and Manufacturing Products (Russia–Tariff Treatment)*, WT/DS485/11, adopted 26 September 2016, para 7.18.

<sup>3</sup>GATT does not require WTO members to bind tariffs. See Matshushita et al. (2015), 218.

<sup>4</sup>General Agreement on Tariffs and Trade 1994, 15 April 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1867 U.N.T.S. 187, 33 I.L.M. 1153 (1994) (GATT), Article I.

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exists between the GATT binding tariff and the applied MFN tariff.<sup>5</sup> For tariff lines with tariff overhang, a WTO member can flexibly raise applied tariffs as long as they are below the GATT bound levels.

The above built-in tariff flexibility is not equally distributed across WTO members. Developing countries in particular have a greater degree of tariff flexibility than developed countries. Even among developing countries, developing countries that joined GATT before 1995 possess a greater degree of tariff flexibility than developing countries that acceded to the WTO after 1995.

Against the backdrop of the unequal distribution of built-in tariff flexibility, suppose a WTO member with substantial built-in tariff flexibility adjusts its rates on a preferential basis by raising applied MFN tariffs for imports from non-parties to the country's preferential trade agreements (PTAs) but not for those originating from its PTA partners.<sup>6</sup> As the imports from non-parties are subject to higher applied tariffs than the imports originating from PTA parties, the tariff preferences for PTA parties are raised.<sup>7</sup>

Studies of the trade effect of tariff preferences are mostly focused on the effects of trade creation and trade diversion caused by the formation of a PTA. Empirical studies show evidence of trade creation but mixed evidence of trade diversion. Using data from North America, Clausing (2001), Trefler (2004), and Romalis (2007, 416, 417) show substantial trade creation effects. However, Clausing finds little evidence of trade diversion from third countries using data from the Canada–US FTA. In another study, Trefler finds greater trade creation than trade diversion, along with the resulting positive welfare effect. In contrast, using NAFTA data, Romalis finds that the trade diversion effect that resulted in a fall in imports from non-NAFTA countries is substantial enough to offset the trade creation effect. Another line of study examines the prices paid by exporters from non-parties to a PTA. Chan and Winters (2002, 889, 901) show an exclusionary effect on exporters from non-parties to MERCOSUR due to the formation of MERCOSUR, a customs union (CU). Because of the formation of MERCOSUR, exporters from non-parties to MERCOSUR had to lower the prices of their exports to MERCOSUR members due to the preferential tariff liberalization between MERCOSUR member countries. The study is further evidence of trade diversion caused by the formation of a PTA.

Tariff preferences due to the formation of a PTA cause both trade creation and trade diversion (Crowley, 2003). In contrast, the discriminatory exercise of built-in tariff flexibility in our study causes trade diversion without trade creation. It results in the reduction of low-cost imports from non-parties and the increase in higher-cost imports from parties to the PTA. This trade effect is analogous to that of anti-dumping duties because the imposition of anti-dumping duties results in a discriminatory increase in tariffs on imports from some exporters but not others. Thus, the studies examining the trade effects of anti-dumping duties can shed light on the effect of the discriminatory exercise of built-in tariff flexibility.

In studying the effect of anti-dumping duties, Prusa (2001) finds that US imports from countries subject to US anti-dumping duties fell by 50–70%. In another study, Bown and Crowley (2007) show that US anti-dumping duties on imports from Japan result in trade deflection,

<sup>5</sup>Tariff overhang arises because even when governments are making commitments to bind tariffs under GATT Article II, they are committing to the upper bounds of applied MFN tariffs rather than the precise tariff levels. See Bagwell and Staiger (2005), 471, 472.

<sup>6</sup>The term PTA in this paper refers to a customs union (CU), a free-trade area, or an interim agreement under GATT Article XXIV. It also refers to a trade agreement under the Enabling Clause (see GATT Document, 'Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries (Enabling Clause)', Decision of 28 November 1979, L/4903, BISD, 26S/203, [www.wto.org/english/docs\\_e/gattdocs\\_e.htm](http://www.wto.org/english/docs_e/gattdocs_e.htm) (visited 30 January 2023)). See GATT Article XXIV:5(a) and chapeau of Article XXIV:5.

<sup>7</sup>Tariff preference is the difference between the applied MFN tariff and the preferential tariff under the country's PTAs. It is capped by the binding tariff level for a bound tariff line, whereas no maximum tariff preference exists for an unbound tariff line.

leading to an increase in Japanese exports to countries other than the US. In yet another study, using Chinese firm-level data, Felbermayr and Sandkamp (2019) present evidence of trade deflection, showing that Chinese firms' exports to third markets increase following the imposition of US anti-dumping duties. The above studies underscore the significant distortions in international trade resulting from a discriminatory increase in tariffs. We can infer from the above studies of anti-dumping duties that the discriminatory exercise of built-in tariff flexibility, which raises tariff preference to imports from PTA partners, causes trade diversion and trade deflection. This means exporters from non-parties have to lower the prices of their exports to the PTA parties or seek alternative markets for their exports.

In view of the above distortionary effect on international trade caused by the discriminatory exercise of built-in tariff flexibility, this paper investigates whether a WTO member's measure to impose additional duties for the tariff lines with built-in tariff flexibility is lawful under PTA and WTO law. Following this introduction, Section 2 provides an overview of built-in tariff flexibility across WTO members. Section 3 provides the legal analysis of the exercise of tariff flexibility in the context of a WTO member's formation of a PTA under GATT Article XXIV and the Enabling Clause,<sup>8</sup> and examines the conflict between PTA obligations and WTO law. Section 4 introduces cases of tariff flexibility exercised by Turkey and India. Section 5 concludes.

## 2. Disparity in Tariff Flexibility

Tariff flexibility is a trade policy response by GATT/WTO governments in the face of substantial uncertainty about the future state of the world at the time the governments negotiated tariff liberalization (Bagwell and Staiger, 2005, 472). One form of tariff flexibility available to all WTO members is administered protection, which lawfully permits tariffs above GATT binding tariff commitments. Administered protection, such as anti-dumping duties, countervailing duties, and safeguard measures, are used as tools to remedy unfair trade or to counter a sudden increase in imports that cause injury to domestic industries.<sup>9</sup> Administrative protection is equally available to all WTO members.

In contrast, built-in tariff flexibility is unequally distributed among WTO members. First, a disparity exists between developed and developing WTO members. Developing WTO members possess greater built-in tariff flexibility than developed members.<sup>10</sup> Second, a less well-known disparity exists between developing members who joined GATT before 1995 (old developing members) and those who have acceded to the WTO since 1995 (new developing members). Old developing members on average gained a greater level of built-in tariff flexibility than new developing members.<sup>11</sup>

Theory and empirical evidence suggest that the size of tariff flexibility is inversely related to measures of a country's import market power.<sup>12</sup> Thus, developing countries with less import market power are likely to have a greater degree of tariff flexibility than developed countries. This prediction accords with the evidence that developing WTO members have

<sup>8</sup>See the Enabling Clause, *supra* n. 6.

<sup>9</sup>An anti-dumping or countervailing duty measure requires proof of 'material injury to an established industry' under GATT Article VI and a safeguard measure under GATT Article XIX requires proof of 'serious injury to its domestic producers' under GATT Article XIX.

<sup>10</sup>See Table 1. Developed WTO members such as the US, the EU, and Japan, maintain virtually no tariff overhangs. See World Tariff Profiles 2021, 8–13, [www.wto.org/english/res\\_e/booksp\\_e/tariff\\_profiles21\\_e.pdf](http://www.wto.org/english/res_e/booksp_e/tariff_profiles21_e.pdf) (accessed 25 March 2022).

<sup>11</sup>See Table 1. The calculation is based on the WTO data that include members that completed accession by 2021. With respect to tariff binding, new developing members such as Vietnam and Cambodia committed to binding 100% of tariff lines, whereas old developing members, such as Kenya and the Philippines, committed to binding 16.3% and 66.9% of tariff lines, respectively.

<sup>12</sup>See Beshkar et al. (2015, 2). The analysis in the article used a country's share of world imports and the elasticity of export supply as measures of a country's market power.

**Table 1.** Tariff Binding Coverage and Overhang of WTO Members

	Developed Members	Developing Members	Old Developing Members	New Developing Members
Average Binding Coverage	99.75	78.70	71.79	99.87
Average Tariff Overhang	1.58	30.46	37.89	6.74

Notes: The calculation is based on the data from the World Tariff Profile 2021, [www.wto.org/english/tratop\\_e/tariffs\\_e/tariff\\_data\\_e.htm](http://www.wto.org/english/tratop_e/tariffs_e/tariff_data_e.htm). The classification of a WTO member's development status follows the World Economic Situation and Prospects 2022 Report, United Nations. The tariff binding coverage is calculated as a percentage of the total HS six-digit subheadings.

higher levels of tariff overhangs and lower levels of binding coverage than developed WTO members.

However, the disparity in tariff flexibility among developing members cannot be explained by import market power because both the old and new developing members have low import market power. Rather, the disparity in tariff flexibility among developing members is attributable to the ways they joined GATT or WTO. During the GATT years, there were two paths to join GATT: succession or accession. A majority of developing countries joined GATT by 'succeeding' to GATT status under the terms of GATT Article XXVI:5(c) rather than by 'acceding' to GATT under GATT Article XXXIII.<sup>13</sup> Succession was an easier route for former colonies of already existing GATT parties, as they could be 'sponsored' by a responsible GATT party.<sup>14</sup> Developing members who joined GATT through succession had lower levels of binding coverage because succession to GATT required fewer tariff commitments than accession (VanGrasstek, 2013, 125). They also bound tariffs at higher MFN levels to allow for higher tariff overhangs.

In comparison, countries applying for membership of the WTO did not have the option of succession. New developing members joined the WTO through the accession process under Article XII of the WTO Agreement.<sup>15</sup> Acceding countries faced a trading system that required a high level of tariff commitments. They bound nearly 100% of tariff lines at lower MFN levels, leaving little room for tariff overhangs. As a result, new developing WTO members ended up with significantly less built-in tariff flexibility than old developing WTO members.

In light of the above disparity in built-in tariff flexibility between WTO members, this paper investigates possible constraints that WTO and PTA laws impose on the utilization of built-in tariff flexibility in Table 1.

### 3. Tariff Flexibility under WTO and PTA Law

#### 3.1 Under WTO Law

##### 3.1.1 GATT Article XXIV

*Discriminatory Rise in Applied MFN Tariffs.* In this section, we first examine the WTO legality of the discriminatory rise in applied MFN tariffs when the WTO member raising the tariff is a party to a PTA under GATT Article XXIV. Suppose a WTO member raises applied MFN tariffs for unbound tariff lines or tariff lines with tariff overhangs on the imports from non-parties to the country's PTAs but not on the imports of like products originating in parties to its PTAs. In this case, the measure results in tariff advantages to the imports originating in the parties to the country's PTAs but not to the imports of like products from non-parties to the country's PTAs,

<sup>13</sup>Ibid., 125.

<sup>14</sup>See GATT Article XXIV:5(c)

<sup>15</sup>Article XII of the Marrakesh Agreement Establishing the World Trade Organization, 15 April, 1994, 1867 U.N.T.S. 154, 33 I.L.M. 1144 (1994) (WTO Agreement) provides for accession to the WTO.

violating GATT Article I. The question is whether the GATT Article I violation of the challenged measure is justified by the GATT Article XXIV exception.

We explore two situations in the following. The first situation is where the timing of the implementation of the challenged measure does not coincide with the formation of the PTA. This can occur if the implementation of the challenged measure occurs after the formation of the country's PTAs. For a measure in violation of GATT Article I to be justified under GATT Article XXIV exception, the Appellate Body under *Turkey-Textiles* provides that the challenged measure should be 'introduced upon the formation' of a CU or a free-trade area.<sup>16</sup> At a minimum, the challenged measure should not be implemented 'after the creation or completion of the PTA' (Marceau and Reiman, 2001, 297, 313). In our case, the challenged measure fails the timing requirement because the introduction of the challenged measure and the formation of the country's PTA do not occur at the same time.<sup>17</sup> Failing the timing requirement of *Turkey-Textiles*, the challenged measure cannot be justified under GATT Article XXIV.<sup>18</sup>

In the second situation, suppose the challenged measure and the formation of the country's PTA take place at the same time. This can happen if the challenged measure is provided as part of the provisions of the country's PTA, for example, in the PTA's plan and schedule. In this case, the challenged measure is introduced upon the adoption of an interim agreement leading to the formation of the PTA within the meaning of Article XXIV:5(c). The Appellate Body justifies the timing requirement on the basis that the introduction of a challenged measure and the process of forming a PTA should not be separated by time.<sup>19</sup> Since the challenged measure is introduced upon the adoption of the interim agreement that leads to the formation of the PTA, the challenged measure should be deemed to satisfy the timing requirement under *Turkey-Textiles*. Satisfying the timing requirement, the challenged measure can succeed in the legal defense against GATT Article I violation if the country's PTA meets the requirements under Article XXIV.<sup>20</sup> The key issue in our case is whether the PTA satisfies the external trade barrier requirement under Article XXIV:5. The external trade barrier requirement under Article XXIV:5 covers a measure that is imposed at the institution, formation, or adoption of the PTAs. In our case, the challenged measure is covered under GATT Article XXIV:5 because the measure is imposed at the time of the formation of the PTAs or the adoption of interim agreements leading to their formation.<sup>21</sup>

Now, with respect to a CU or its interim agreement, Article XXIV:5(a) is not met because the duties on imports from non-parties 'imposed at the institution of any such union or interim agreement' are higher than those 'applicable' prior to the formation of the CU or the adoption of the interim agreement. The comparison is made on the basis of 'the applied rates of duty' in accordance with the Understanding on the Interpretation of Article XXIV of the GATT

<sup>16</sup>See Appellate Body Report, *Turkey-Restrictions on Imports of Textile and Clothing Products (Turkey-Textiles)*, WT/DS34/AB/R, adopted 19 November 1999, para. 58. Though the Appellate Body in *Turkey-Textiles* dealt with a challenged measure in connection with the formation of a CU, *Turkey-Textiles* should equally apply to a challenged measure adopted in connection with the formation of a free-trade area. It also applies to an interim agreement leading to the formation of a CU or a free-trade area. This is because the GATT inconsistency of a measure adopted to form a free-trade area or an interim agreement is also covered under GATT Article XXIV.

<sup>17</sup>In *Turkey-Textiles*, the timing requirement was met with respect to the CU between the EU and Turkey because the timing of the formation of the CU and the enactment of the challenged measure coincided with each other. See Appellate Body, *Turkey-Textiles*, supra n. 16, para. 2.

<sup>18</sup>*Turkey-Textiles* provides that the WTO member adopting the challenged measure should demonstrate that the challenged measure is necessary for the formation of the PTA. In our case, the challenged measure fails the necessity test because the PTA was formed before the introduction of the challenged measure.

<sup>19</sup>The timing requirement under *Turkey-Textiles* is based on the text of the chapeau, which states that the provisions of the GATT 1994 shall not prevent 'the formation of a customs union'. See Appellate Body, *Turkey-Textiles*, supra n. 16, para. 46.

<sup>20</sup>*Ibid.*, para. 58.

<sup>21</sup>We use the term 'formation' to refer to the term institution, formation, or adoption used in Article XXIV:5.

1994 of the WTO Agreement (Understanding).<sup>22</sup> Likewise, for a free-trade area or its interim agreement, Article XXIV:5(b) is not met because the duties on imports from non-parties ‘maintained ... and applicable at the formation of the free-trade area or the adoption of the interim agreement’ are higher than those ‘existing’ before the formation of the free-trade area or the adoption of the interim agreement.<sup>23</sup> Here, to be in line with Article XXIV:5(a) for a CU, the duties ‘maintained ... and applicable’ under Article XXIV:5(b) for a free-trade area should be deemed applied rates of duty.<sup>24</sup> Since the applied duties on imports from non-parties have been raised, the challenged measure fails the external trade barrier requirement under GATT Article XXIV:5(b). To summarize, if the challenged measure is introduced at the time of the formation of the PTA, it does not succeed in the legal defense against GATT Article I violation.

*Non-discriminatory Rise in Applied MFN Tariffs.* The previous section shows that the discriminatory exercise of built-in tariff flexibility for a WTO member forming a PTA under GATT Article XXIV is not justified under GATT Article XXIV. Then, the question arises whether the non-discriminatory exercise of built-in tariff flexibility is permitted under WTO law. The non-discriminatory rise in the applied MFN tariffs does not violate GATT Article I because it applies to both products originating in PTA parties and like products imported from non-parties to the country’s PTA. Nor does it violate GATT Article II because the tariffs are either unbound under GATT Article II or raised within the binding ceilings. Therefore, the measure, in and of itself, is not challengeable for violation of the GATT. Nevertheless, the measure may affect the compliance of the country’s PTA with GATT Article XXIV (Mathis, 2002).

The key question that arises is whether the non-discriminatory rise in applied MFN tariffs affects the PTA’s fulfillment of the GATT Article XXIV:5 requirement.<sup>25</sup> If the measure to raise applied MFN tariffs is implemented after the formation of a PTA, the measure is not covered under Article XXIV:5. However, if the measure to raise applied MFN tariffs is implemented at the formation of a PTA, the measure would be in violation of GATT Article XXIV:5 as tariffs applied at the formation of the PTA are made higher than those existing prior to its formation.

The non-discriminatory rise in applied MFN tariffs may also have an effect on the internal trade liberalization requirement under GATT Article XXIV:8 because the applied tariffs on imports originating in parties to the PTA are raised as well. The rise in the tariffs on the imports originating from the PTA parties rolls back the elimination of duties. As a result, the question arises as to whether the elimination of tariffs between the PTA parties covers ‘substantially all the trade’ under GATT Article XXIV:8. According to *Turkey-Textiles*, the internal trade requirement offers ‘some flexibility’ to the WTO members forming a PTA. The flexibility is limited by the constraint that the elimination of ‘duties and other restrictive regulations of commerce’ should cover ‘substantially all’ internal trade.<sup>26</sup> So long as the result of the internal tariff elimination covers ‘something considerably more than merely *some* of the trade’ (emphasis original), the fulfillment of the requirement under Article XXIV:8 will not be affected.<sup>27</sup> Likewise, the external harmonization requirement for a CU under Article XXIV:8

<sup>22</sup>See paragraph 2 of the Understanding. Prior to the clarification made in the Understanding, some GATT parties contended that duties ‘applicable’ mean GATT bound duties. See GATT Document, Article XXIV, Paragraph 5(a): Interpretation of the word ‘applicable’, Note by the Executive Secretary, L/1919, 14 November 1962, [www.wto.org/english/docs\\_e/gattdocs\\_e.htm](http://www.wto.org/english/docs_e/gattdocs_e.htm) (visited 2 January 2023).

<sup>23</sup>See GATT Article XXIV:5(b).

<sup>24</sup>To interpret duties ‘maintained ... and applicable’ as GATT bound duties would render Article XXIV:5(b) meaningless because GATT bound duties do not change upon formation of a PTA.

<sup>25</sup>Under GATT Article XXIV:5, the term ‘institution’ refers to creation of a CU or its interim agreement; the terms ‘formation’ and ‘adoption’ refer to creation of a free-trade area and its interim agreement, respectively. To simply the terms, this paper uses the term ‘formation’ to refer to creation of a PTA.

<sup>26</sup>See *Turkey-Textiles*, supra n. 16, para. 48.

<sup>27</sup>Ibid.

(a)(ii) will not be affected unless the rise in applied MFN tariffs prevents the common external tariffs from achieving ‘something closely approximating “sameness”’.<sup>28</sup> To conclude, a WTO member’s use of built-in tariff flexibility on a non-discriminatory basis does not affect the compliance of the member’s PTA with GATT Article XXIV unless the measure is implemented at the formation of the member’s PTA.

### 3.1.2 The Enabling Clause

*Discriminatory Rise in Applied MFN Tariffs.* Developing WTO members may choose to enter into a PTA under the Enabling Clause with each other ‘for the mutual reduction or elimination’ of tariff and non-tariff barriers to trade.<sup>29</sup> The mutual reduction or elimination of tariffs between the PTA parties results in an MFN violation under GATT Article I. Nevertheless, the GATT Article I inconsistency is justified under the Enabling Clause, provided that the conditions set out in the Enabling Clause are met.<sup>30</sup>

Paragraph 3(a) of the Enabling Clause provides two conditions. First, a PTA under the Enabling Clause first ‘shall be designed to facilitate and promote the trade of developing countries’, and second, ‘[shall be designed] not to raise barriers to or create undue difficulties for the trade of any other contracting parties’.<sup>31</sup> In contrast to the requirements under GATT Article XXIV, the Enabling Clause does not provide operational rules that correspond to GATT Article XXIV:8 and Article XXIV:5. Nonetheless, we can raise the question whether the GATT Article I violation of the challenged measure is justified under the Enabling Clause. To begin with, the Appellate Body in *Brazil–Taxation* requires that the challenged measure should have ‘a “genuine” link or a rational connection with the regional or global arrangement adopted and notified to the WTO’ so that the challenged measure could be considered to have been adopted pursuant to paragraph 2(c) of the Enabling Clause.<sup>32</sup> In our case, the challenged measure can be deemed to have a genuine link with the PTA because the applied tariffs are raised only on imports from non-parties to the PTA.

To succeed in a legal defense under the Enabling Clause, the PTA should satisfy the two conditions provided in paragraph 3(a) of the Enabling Clause. Lacking operational rules, the conditions under the Enabling Clause are more aspirational standards rather than enforceable rules. Even so, the first condition is met because the challenged measure does not raise tariffs on imports originating from the PTA parties. Moreover, the trade diversion due to the rise in applied tariffs on imports from non-parties facilitates trade between the PTA parties that are developing countries. The second condition is also satisfied because the measure is not ‘designed to raise barriers to or create undue difficulties for the trade of any other contracting parties’. This is because applied tariffs may have been temporarily lowered before they are raised back to bound tariffs.<sup>33</sup> Thus, it cannot be considered that there was a design to raise barriers to the trade of non-parties. Moreover, the effect of the measure may not be considered ‘undue difficulties’ for the trade of non-parties because non-parties are already on notice that applied tariffs can be raised for GATT unbound tariff lines and tariff lines with tariff overhangs. To summarize, the measure is likely to succeed in the legal defense under the Enabling Clause against GATT Article I inconsistency.

<sup>28</sup>The external harmonization requirement for a CU like the internal trade requirement leaves room for flexibility. See *Turkey–Textiles*, supra n. 16, para. 40.

<sup>29</sup>*Ibid.*, para. 2(c) of the Enabling Clause, supra n. 6.

<sup>30</sup>See also WTO Appellate Body, *European Communities – Conditions for the Granting of Tariff Preferences to Developing Countries (EC–Tariff Preferences)*, WT/DS246/AB/R, adopted 20 April 2004, para. 90.

<sup>31</sup>See paragraph 3(a) of the Enabling Clause, supra n. 6.

<sup>32</sup>See WTO Appellate Body Report, *Brazil – Certain Measures Concerning Taxation and Charges (Brazil–Taxation)*, WT/DS497/AB/R, WT/DS472/AB/R, adopted on 11 January 2019, para. 5.423. In contrast to the analysis under GATT Article XXIV, there is no legal basis for applying the timing requirement or the necessity test outlined in *Turkey–Textiles*.

<sup>33</sup>See GATT Document, Article XXIV, para. 5(a): Interpretation of the word ‘applicable’, supra n. 22.

*Non-discriminatory Rise in Applied MFN Tariffs.* A WTO member that forms a PTA under the Enabling Clause may use built-in tariff flexibility on a non-discriminatory basis. The non-discriminatory rise in applied tariffs does not contravene GATT Article I because applied tariffs are raised on imports originating from PTA parties as well as non-parties. The remaining question is whether the measure affects the PTA's fulfillment of the two conditions under paragraph 3(a) of the Enabling Clause. The first condition requires facilitation and promotion of trade between developing countries. The requirement will be satisfied unless 'mutual reduction or elimination' of tariffs is entirely reversed, in which case the PTA no longer exists. In addition, the challenged measure must meet the second condition. As previously argued, the second condition is met because the measure is not designed to raise barriers to or create undue difficulties for the trade of any other contracting parties. To summarize, the non-discriminatory use of built-in tariff flexibility by a WTO member does not affect the lawfulness of the member's PTA under the Enabling Clause.

### 3.2 Under PTA Law

Under PTA law, the parties to a PTA under GATT Article XXIV or the Enabling Clause commit to liberalizing tariffs on imports originating from the PTA parties under the tariff liberalization schedule of the PTA.<sup>34</sup> Thus, if a PTA party raises applied MFN tariffs on a non-discriminatory basis, it results in violation of the binding tariff liberalization commitments under the PTA because the applied tariffs covered by the PTA tariff liberalization schedule are raised.

Even for those tariff lines that are not covered by the PTA tariff liberalization schedule, PTA parties commit to leaving the market no less open than it was at the time of enactment of the agreement through a standstill clause. A generic standstill clause in the trade-in-goods chapter of a PTA provides that 'neither Party shall increase any existing customs duty, or adopt any new customs duty, on an originating good of the other Party'.<sup>35</sup> The standstill clause, which is applicable to all tariff lines including those that are not covered by the PTA tariff concession schedules, prevents the parties from raising applied MFN tariffs on imports originating from the parties to a PTA. To summarize, PTA law prohibits PTA parties from raising the applied tariffs on imports originating from the PTA parties even if the tariff lines are benefiting from built-in tariff flexibility.

### 3.3 The conflict between WTO and PTA law

A conflict arises between WTO law and PTA law if a WTO member that is a party to a PTA under GATT Article XXIV exercises built-in tariff flexibility. On the one hand, if a WTO member adopts a measure to raise applied MFN tariffs on a non-discriminatory basis for all imports including those originating from the PTA parties, the measure violates the member's commitments under its PTAs. On the other hand, if a WTO member adopts a measure to raise applied MFN tariffs discriminatorily on imports only from non-parties to its PTAs, the measure contravenes WTO law. Since it is not possible to comply with both WTO and PTA obligations simultaneously, there is a conflict between the WTO and PTA law when a WTO member that is a party to a PTA under GATT Article XXIV exercises built-in tariff flexibility. Then, the question arises whether this conflict can be resolved by a conflicts-of-law provision in a PTA. A typical conflicts-of-law provision in a PTA states that '[n]othing in this Agreement shall derogate from the existing rights and obligations of a Party under the WTO Agreement'.<sup>36</sup> Under this rule, the provisions of the WTO Agreement prevail over the provisions of the PTA. Therefore, the exercise of tariff flexibility should be on a non-discriminatory basis in accordance with WTO law.

<sup>34</sup>GATT Article XXIV requires elimination, but the Enabling Clause requires reduction or elimination of tariffs with respect to imports originating from the PTA parties.

<sup>35</sup>See Article 2.4 of The Agreement on Trade in Goods between Turkey and the Republic of Korea (Korea–Turkey FTA).

<sup>36</sup>See Article 1.3, Free Trade agreement Between the Government of the Republic of Turkey and the Government of Malaysia (Turkey–Malaysia FTA).



In contrast, a conflicts-of-law provision in a PTA may allow a modification of WTO law by PTA provisions. The conflicts-of-law provision in the Peru–Guatemala FTA, which has not yet come into effect, provides that ‘[i]n the event of any inconsistency between this Treaty and [the WTO Agreement], this Treaty shall prevail to the extent of the inconsistency, except as otherwise provided in this Treaty’.<sup>37</sup> Under the conflicts-of-law clause, PTA provisions arguably prevail over WTO rules. However, the Appellate Body in *Peru–Agricultural Products* questioned whether the conflicts-of-law provision in the Peru–Guatemala FTA could modify WTO obligations.<sup>38</sup> The WTO dispute was over whether the price range system (PRS) in the Peru–Guatemala FTA is permitted under WTO law. The panel and the Appellate Body found that Peru’s PRS was inconsistent with GATT Article II:1(b) and Article 4.2 of the Agreement on Agriculture because the PRS resulted in duties that were not ‘ordinary customs duties’.<sup>39</sup> The Appellate Body held that the PTA provision that permits Peru to maintain the PRS system could not modify Peru’s WTO commitments despite the conflicts-of-law provision in the Peru–Guatemala FTA. The Appellate body reasoned that specific provisions such as GATT Article XXIV for the formation of a PTA cover the modification of WTO rules rather than Article 41 of the Vienna Convention, which allows the possibility of modification of a multilateral treaty by two or more of the parties to that treaty.<sup>40</sup> This means that a modification of GATT obligations is not permitted even if a special conflicts-of-law rule in a PTA allows modification of the WTO Agreement.

In our case, we note that the measure to raise the applied MFN tariffs discriminatorily after the formation of the PTAs causes an MFN violation under GATT Article I. Therefore, for the measure to succeed in a legal defense under GATT Article XXIV, the member’s PTA should satisfy the *Turkey–Textiles* test.<sup>41</sup> The challenged measure fails the timing requirement under *Turkey–Textiles* because the discriminatory rise in the applied tariffs takes place after the formation of the PTA.<sup>42</sup> Therefore, the measure does not succeed in the legal defense under GATT Article XXIV against GATT Article I violation. No less importantly, even if the measure satisfies the timing requirement, the measure fails to meet GATT Article XXIV:5, as it raises duties on imports from non-parties to the member’s PTA.

In contrast to the above, if a WTO member is a party to PTAs under the Enabling Clause, the conflict between PTA law and WTO law does not arise because the member’s discriminatory exercise of tariff flexibility succeeds in the legal defense under the Enabling Clause against GATT Article I violation. Thus, the WTO member that exclusively enters into Enabling Clause PTAs is not prevented from exercising built-in tariff flexibility preferentially for imports from its PTA partners. In the following section, we investigate two cases of the use of built-in tariff flexibility by WTO members.

#### 4. Cases of Discriminatory Exercise of Tariff Flexibility

India and Turkey are examples of WTO members in possession of substantial built-in tariff flexibility due to unbound tariff lines and tariff overhangs.<sup>43</sup> Both raised applied MFN tariffs

<sup>37</sup>See *Peru – Additional Duty on Imports of Certain Agricultural Products (Peru–Agricultural Products)*, WT/DS457/AB/R, adopted on 31 July 2015, footnote to para. 5.26.

<sup>38</sup>*Ibid.*, para. 5.111.

<sup>39</sup>*Ibid.*, para. 5.76.

<sup>40</sup>*Ibid.*, para. 5.112. Commenting on the Appellate Body’s decision, Shaffer and Winters (2017) contend that a PTA obligation that modifies WTO obligations should be recognized by WTO panels as a defense, subject to the PTA satisfying the requirements under GATT Article XXIV. See Shaffer and A. Winters (2017, 30).

<sup>41</sup>See *Ibid.*, 322.

<sup>42</sup>Failing the timing requirement, the measure also fails the necessity test because the PTAs had already been formed before the measure was adopted.

<sup>43</sup>Turkey’s tariff binding coverage is 50.5% and the average tariff overhang is 17.8%. See *World Tariff Profiles 2021*, supra n. 10.

discriminatorily only on imports from non-parties to its PTAs. We first discuss the case of Turkey followed by that of India.

#### 4.1 Turkey

Turkey is a party to 22 PTAs under GATT Article XXIV and one PTA under the Enabling Clause (Egypt–Turkey FTA) that are in force as of February 2023.<sup>44</sup> Turkey imposed additional duties between 2014 and 2016 on a wide range of industrial goods.<sup>45</sup> The additional duties were levied up to 150% of the corresponding statutory tariffs.<sup>46</sup> The tariff lines subject to additional duties were unbound under GATT Article II or had tariff overhangs if they were bound.

While imposing additional duties on the imports from non-parties to its PTAs, Turkey did not raise tariffs on the imports originating from its PTA parties.<sup>47</sup> If Turkey were to impose additional tariffs on imports from its PTA parties, the measure would have violated Turkey's tariff elimination commitments and the standstill clauses provided in Turkey's PTAs.<sup>48</sup> Thus, in exercising tariff flexibility, Turkey has remained in conformity with its obligations under its PTAs but was in violation of GATT Article I by raising its applied MFN tariffs only on imports from non-parties to its PTAs.<sup>49</sup> Turkey's PTA obligations prevailed over its WTO obligations, thus resulting in *de facto* modification of WTO law. The question is whether the GATT inconsistency of the measure is justified by the GATT Article XXIV exception for Turkey's PTAs under GATT Article XXIV.

In analyzing whether Turkey's measure succeeds in a legal defense against GATT Article I violation, we apply the test under *Turkey–Textiles*. The challenged measure was implemented between 2014 and 2016 after PTAs with the EU, Syria, Albania, Georgia, Montenegro, Serbia, Chile, Korea, Mauritius, Moldova, and Malaysia came into force.<sup>50</sup> Thus, the timing requirement under *Turkey–Textiles* is not met for the PTAs.<sup>51</sup> Therefore, Turkey's measure to impose additional customs duties on imports from non-parties to its PTAs cannot be justified under GATT Article XXIV because the measure fails the timing requirement under *Turkey–Textiles*.

<sup>44</sup>See Regional Trade Agreements Database, available at <http://rtais.wto.org/UI/PublicMaintainPTAHome.aspx>.

<sup>45</sup>See 2021 National Trade Estimate Report on Foreign Trade Barriers, USTR 499, <https://ustr.gov/sites/default/files/files/reports/2021/2021NTE.pdf> (accessed 7 February 2022). See also European Commission, DG TRADE, Access2Markets, Additional Customs Duties, Reported on 12 January 2017, updated on 17 January 2022, [https://trade.ec.europa.eu/access-to-markets/en/barriers/details?barrier\\_id=12260&sps=false](https://trade.ec.europa.eu/access-to-markets/en/barriers/details?barrier_id=12260&sps=false) (accessed 7 February 2022).

<sup>46</sup>Additional tariffs were levied through the following customs Decrees: Decree 2014/6692 Turkish Official Gazette (OG) No. 29076, Decree 2014/6884 OG No. 29149, Decree 2014/6885 OG No. 29149, Decree 2015/7241 OG No. 29259, Decree 2015/7252 OG No. 29271, Decree 2015/7699 OG No. 29364, Decree 2015/7712 OG No. 29379, Decree 2015/7713 OG No. 29379, Decree 2015/7722 OG No. 29392, Decree 2015/7749 OG No. 29407, Decree 2016/9391 OG No. 29885, Decree 2016/9422 OG No. 29885, and Decree 2016/9640 OG No. 29935 (Decrees), [www.resmigazete.gov.tr](http://www.resmigazete.gov.tr) (accessed 9 February 2022).

<sup>47</sup>Additional customs duties were not imposed on imports from countries Turkey had entered into PTAs with at the time of the implementation of the Decrees: EU member countries, EFTA member countries, Israel, Macedonia, Bosnia and Herzegovina, Morocco, Western Bank and Gaza Strip, Tunisia, Egypt, Georgia, Albania, Jordan, Chili, Serbia, Montenegro, Kosovo, Moldova, South Korea, Mauritius, and Malaysia. *Ibid.*

<sup>48</sup>Except for Turkey–Kosovo FTA and the United Kingdom–Turkey FTA, all other PTAs under GATT Article XXIV and the Enabling Clause include a standstill clause.

<sup>49</sup>An example of a product covered by the Decree is hand tools (HS 8205). The applied MFN tariffs for tariff lines under hand tools (HS 8205) ranged from 1.7% to 3.7%. Upon the enactment of Decree No. 2015/7241, the applied MFN tariffs for all tariff lines under hand tools (HS 8205) were raised to 25% with respect to imports from third countries, while the duties on imports originating in Turkey's PTA parties were kept at zero.

<sup>50</sup>See Regional Trade Agreement, Database, PTAs in Force, *supra* n. 44.

<sup>51</sup>As a corollary to failing the timing requirement, the challenged measure fails the necessity test under *Turkey–Textiles* because the PTAs had already been formed at the time of the implementation of the measure. The necessity of the measure for the formation of Turkey's PTAs is further refuted by Turkey's statement that it imposed additional duties to protect its industries as the applied MFN tariffs did not provide 'adequate protection' to its domestic industries. See Trade Policy Review, Turkey, Minutes of Meeting, WT/TPR/M/192/Add.1, 13 March 2008, 41.

Even if the timing requirement were met, Turkey's PTAs fail to conform to Article XXIV:5 because duties applicable on the imports from the non-parties were higher at the formation of the PTAs than the corresponding duties before the formation of the PTAs.

Turkey also concluded the Egypt–Turkey FTA, a PTA under the Enabling Clause. Turkey did not raise the applied tariffs on imports from Egypt in accordance with its obligations under the PTA. As discussed in Section 4.1, the discriminatory exercise of Turkey's built-in tariff flexibility succeeds in a legal defense under the Enabling Clause against GATT Article I violation.<sup>52</sup>

#### 4.2 India

India is a party to 15 PTAs under the Enabling Clause, two PTAs under GATT Article XXIV, and one PTA dually notified under both the Enabling Clause and GATT Article XXIV as of February 2023.<sup>53</sup> India has substantial built-in tariff flexibility due to a significant number of both unbound tariff lines and tariff overhangs.<sup>54</sup> India used built-in tariff flexibility by raising tariffs in the 2019/2020 budget year on a wide range of products.<sup>55</sup> The tariff increase covered 2,319 products, representing 45.3% of the tariff lines subject to *ad valorem* tariffs.<sup>56</sup> As a result, the simple average of MFN applied tariffs for non-agricultural products increased from 9.5% in 2014/15 to 12.3% in 2020/21.<sup>57</sup>

India's tariff increase did not apply to imports originating from India's PTA partners, resulting in a GATT Article I violation.<sup>58</sup> As previously discussed in Section 4.1, the GATT Article I violation due to the discriminatory exercise of India's built-in tariff flexibility is likely to be justified under the Enabling Clause. However, with respect to the India–Japan FTA and India–Singapore FTA based on GATT Article XXIV, the challenged measure is not likely to succeed in a legal defense under GATT Article XXIV against GATT Article I violation.

### 5. Conclusion

Tariff flexibility due to GATT unbound tariff lines or tariff overhangs is lawfully allowed for WTO members, though it is available to a greater extent for some WTO members than others. This paper investigates the legal constraints faced by WTO members in utilizing tariff flexibility. The results show that legal constraints vary depending on whether a WTO member's PTA is based on GATT Article XXIV or the Enabling Clause. A WTO member that is a party to a PTA under GATT Article XXIV may lawfully exercise built-in tariff flexibility on a non-discriminatory basis. However, PTA obligations including tariff elimination commitments and standstill clauses provided in a PTA prevent WTO members from exercising built-in tariff flexibility on a non-discriminatory basis. In contrast, a WTO member forming a PTA under the Enabling Clause may lawfully exercise built-in tariff flexibility discriminatorily under the Enabling Clause by raising applied tariffs only on imports from the non-parties to the PTA. Thus, a WTO member has greater legal latitude in utilizing built-in tariff flexibility when it forms a PTA under the Enabling Clause than under GATT Article XXIV.

This paper examined cases of Turkey and India's use of built-in tariff flexibility. The WTO members raised applied MFN tariffs on imports from the non-parties to their PTAs but not

<sup>52</sup>See paragraph 3(a) of the Enabling Clause, *supra* n. 6.

<sup>53</sup>See Regional Trade Agreements Database, *supra* n. 44.

<sup>54</sup>India's unbound tariff lines account for 25.7%. India's average tariff overhang is 33.2%. See *World Tariff Profiles 2021*, *supra* n. *supra* n. 10.

<sup>55</sup>Products subject to India's additional tariffs include information and communications technology products, medical devices, paper products, chemicals, and automotive parts, among others. See 2021 National Trade Estimate Report on Foreign Trade Barriers, USTR, *supra* n. 45, 246.

<sup>56</sup>See Shiino (2021).

<sup>57</sup>See Trade Policy Review, India, Report by the Secretariat, 16 March 2021, WT/TPR/S/403/Rev.1, 47.

<sup>58</sup>The increased preferential margins for imports from India's PTA partners caused trade diversion. See Shiino (2021).

on those originating from the parties to their PTAs. They chose to adhere to PTA commitments over their WTO obligations. The discriminatory increase in applied MFN tariffs by the WTO members can be viewed as *de facto* modification of WTO law by PTA obligations.

Though the analysis in this paper is focused on trade in goods, a similar flexibility arises in the context of trade in services. Analogous to unbound tariff lines, a WTO member is provided with flexibility under the General Agreement on Trade in Services (GATS) in the sectors where it did not make binding specific commitments with respect to market access under GATS Article XVI or national treatment under GATS Article XVII. Similarly, a WTO member is also provided with flexibility that is analogous to tariff overhang if it is applying restrictions that are at levels more favorable than the binding minimum standard specified in the country's market access schedule under GATS Article XVI.

As in the case of tariff flexibility, a question arises whether a WTO member forming a PTA in trade in services may lawfully add restrictions in market access or withdraw national treatment for non-PTA countries in service sectors where it is provided with the above flexibility.<sup>59</sup> Like the case of tariff flexibility, the exception under the GATS Article V on economic integration does not permit a WTO member to raise 'the overall level of barriers to trade in services' compared to the level applicable before the formation of a PTA.<sup>60</sup> Nevertheless, it is likely that some WTO members are raising the barriers to trade in services discriminatorily for non-PTA parties but not for PTA parties in accordance with PTA commitments. Further research is necessary to assess the extent of a WTO member's discriminatory exercise of flexibility in trade in services.

This paper shows that a WTO member's discriminatory exercise of tariff flexibility explicitly increases tariff barriers on imports from non-parties to the WTO member's PTAs. It causes distortions in the trading system without any offsetting welfare improvement. The practice of a PTA party giving more favorable treatment to its PTA partners may also be found in PTAs in services. As the enforceability of WTO law is weakened, the political reality of a PTA party may drive protectionism aimed at non-parties to its PTAs, abrogating the WTO legal constraint that prohibits a PTA party from raising barriers to trade with third countries. Closer economic integration between PTA partners may be accelerated by the weakened oversight of PTAs under WTO law, which could increase the risk of further fragmentation of the trading system.

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<sup>59</sup>The GATS trade liberalization in service is based on a positive list approach. Those service sectors and modes of supply that are not explicitly bound in a member's specific schedule are not subject to market access and national treatment obligations under the GATS. Thus, a WTO member can flexibly determine its liberalization in terms of market access and national treatment where it did not make binding commitments. See Article XVI and XVII of the GATS.

<sup>60</sup>See paragraph 4 of Article 5 of the GATS.

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